Office of Chief Counsel Internal Revenue Service

memorandum CC: TL-N-115-00

date: FEB 1 7 2000

to: Examination Division,

ATTN:

from: Associate District Counsel,

subject: ADVISORY OPINION -

Taxpayer:

TIN:

Taxable Years:

DISCLOSURE STATEMENT

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This memorandum responds to your January 5, 2000, request for advice concerning the appropriate tax treatment of expenditures

made to settle arbitration and litigation claims, and amounts received in settlement of another claim. This advice is based on the facts as provided in your January 5, 2000 memorandum, which we have attempted to summarize below. If any of the facts are not as stated, you should provide us with the additional facts so that we can determine whether our advice requires revision.

ISSUES

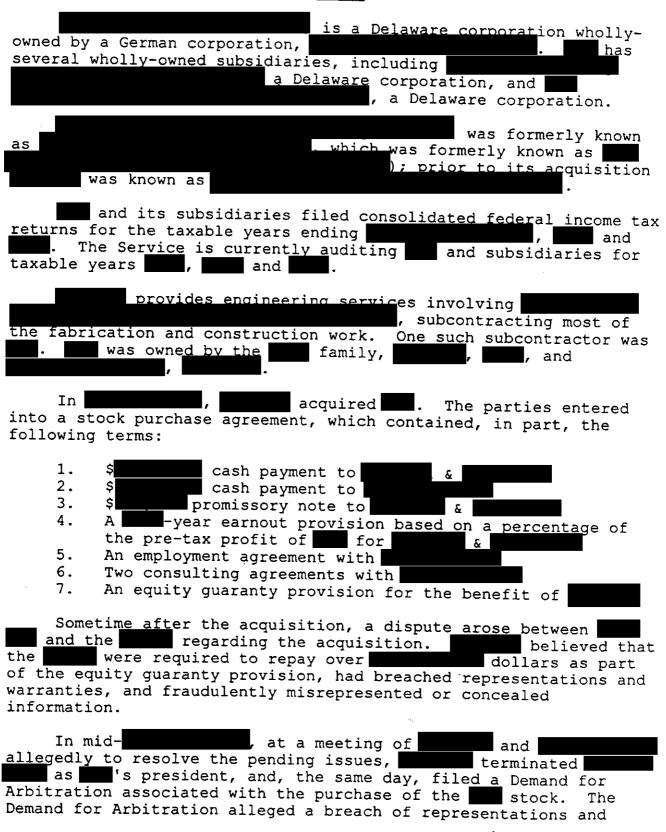
- I. Whether \$ paid by the taxpayer to the in in settlement of arbitration claims and related litigations is currently deductible.
- II. Whether \$ _____ received by the taxpayer in settlement of its claim against _____ in ____ is includible in income.

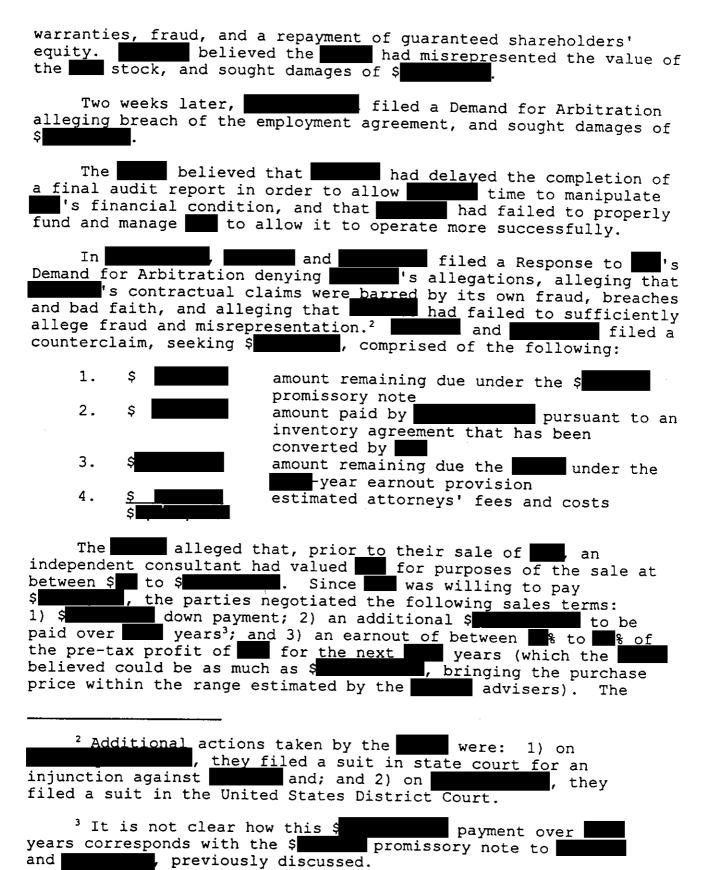
CONCLUSION

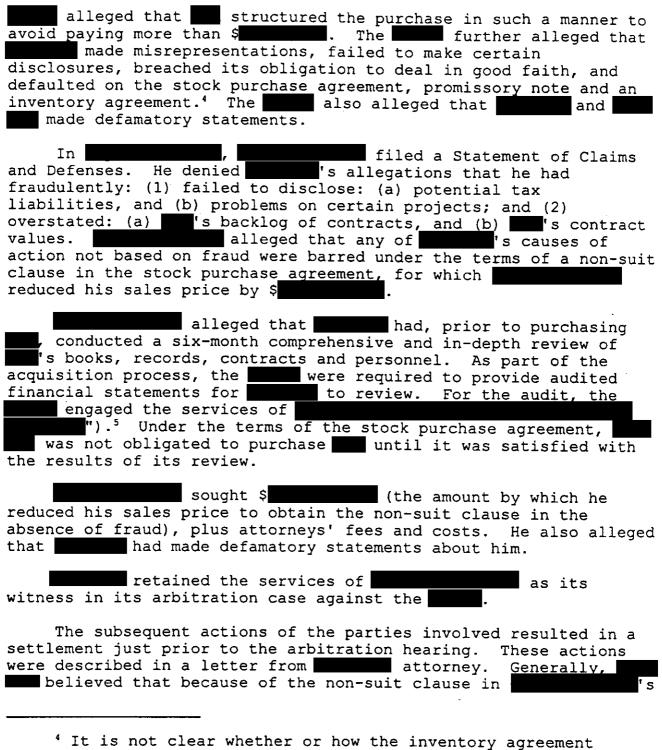
- I. The treatment of the \$ paid by the taxpayer in in settlement of arbitration claims, and related litigation claims, appears to be primarily an expense that should be capitalized to the extent that the origins of the claims are related to the taxpayer's acquisition of a new business. As one of the claims being settled related to a breach of an employment contract, it is possible that, to the extent that a portion of the settlement can be determined to relate to that claim, the taxpayer might be entitled to a current deduction for a portion of the settlement. Legal fees incurred by the taxpayer should be allocated along the lines of the related settlement income.
- II. The \$ settlement proceeds received by the taxpayer in should be given consistent tax treatment (i.e., ordinary or capital) as the \$ settlement expense paid by the taxpayer in .

The initial inquiry from the Examination Division is set forth in issue two. We have also addressed your other inquiry, which you appear to have added after preparation of the request for the initial inquiry, which is: "Also, the question comes up if we should take an inconsistent alternative position [that] the second agent's report." We have addressed the additional inquiry as issue one.

FACTS







^{&#}x27;It is not clear whether or how the inventory agreement relates to the stock purchase agreement.

⁵ Although the apparently engaged , it is unclear whether it was the who selected . According to sattorney, during the arbitration the denied that they selected .

^{&#}x27;s attorney states that prior to any engagement of by the in connection with the acquisition, both and disclosed to the that also worked, on a worldwide basis, for German parent, and that during the arbitration the especially vigorous in denying any such disclosure.

effect" on the other issues was viewed to be staggering, increasing significantly the chance that the could establish the veracity of their claims, thus making it prudent for to pay to discharge the claims rather than to risk trying them. As to claims, paid him because it could not effectively dispute his claims and because he had a good chance of proving that the arbitration was initiated because of 's tortious conduct.

On 's attorney wrote a letter to state a state of the secret communications between and was appalling,

on 's attorney wrote a letter to 's attorney pointing out that the existence of the secret communications between and was appalling, and the subsequent withholding of the documentary evidence of those communications was an outrage. 's attorney stated that those and other facts indicated that 's claims were concocted, and were being pursued in bad faith.

Three days later, on ______, ____ agreed to the settlement with the _____. The settlement called for _____ to pay \$_____ to ____ and _____, as follows:

Reimbursement to and for costs incurred in the litigation and arbitration matters being settled;

Compensation for personal injury to the personal reputations, personal embarrassment, mental and physical strain, and emotional damages as asserted in their defamation claims

Repayment of monies given to pursuant to the inventory agreement

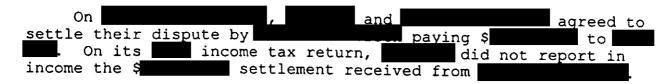
paid paid \$ which was not allocated in specific amounts, between the following two categories:

- 1. Reimbursement for costs incurred by ______ in connection with the litigation and arbitration matters;
- 2. Compensation for personal injury to personal reputations, personal embarrassment, mental and physical strain, and emotional damages as asserted in his defamation claims.

Finally, as part of the settlement, the assigned to any rights they had, or thereafter acquired, to all claims they may have had against to be a settlement, together with a pledge of cooperation in the prosecution of any such claims.

the	On its income tax return, settlement paid to the , com	deducted \$ as follows:	for
	Amount paid to the Plus Invoice Plus arbitration expenses	\$	6
	LESS: Payment to related to inventory agreement Accrued interest (deducted elsewhere) Balance of Promissory Note adjustment Reduction of Purchase price	\$	ş
communote agreed	on sention to commence a civil action based on self-iduciary duties to self-iduciary duties. Specifically, continuing to represent self-iduciations with the purchaser, self-iduciations with the purchaser, self-iduciations with the purchaser, self-iduciations with the purchaser, self-iduciation of the action o	alleged breach of who had retained refent and engage in audit, s to challenge that the audit cont cons and omissions. sulting with or dis	of its ethical erred to also then ained All of
expe \$ been disc writ liti esta	explaining that 's conduct substantially contacts rely responsible for, section of recovering \$	cosition swinging for to its having to put that countries that cou	was not rom an ay which had g, failed to

⁷ The facts do not explain the precise identity of For purposes of this opinion, we have assumed that it is the German parent,



DISCUSSION

I. LAW

I.R.C. section 61(a) defines gross income as "all income from whatever source derived," subject to certain exclusions provided in the Code. Accordingly, any funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-31 (1955); Getty v. Commissioner, 913 F.2d 1486, 1490 (9th Cir. 1990), revg. 91 T.C. 160 (1988).

A deduction shall be allowed for all ordinary and necessary expenses paid during the taxable year in carrying on a taxpayer's trade or business. I.R.C. § 162; Treas. Regs. § 1.162-1. An expense is ordinary if it arises out of the normal operations of the business. Deputy v. du Pont, 308 U.S. 488 (1940). An expense is necessary if it is appropriate and helpful to the taxpayer's business. Welch v. Helvering, 290 U.S. 111, 114 (1933).

Code section 263 provides that no deduction is allowed for capital expenditures. Included in those expenses to be capitalized are those that are for the acquisition or disposition of capital assets. Woodward v. Commissioner, 397 U.S. 572, 575 (1970); United States v. Hilton, 397 U.S. 580 (1970). Treas. Reg. § 1.212-1(n) and 1.263(a)-2(a). Such expenditures are included in "the basis of the capital asset with respect to which they are incurred and are taken into account for tax purposes either through depreciation or by reducing the capital gain ... when the asset is sold." Woodward, 397 U.S. at 574-5; I.R.C. § 1001.

Legal expenses and settlement costs incurred in defending against a claim of fraud that would injure or destroy a business have been held to be ordinary and necessary business expenses.

Commissioner v. Heininger, 320 U.S. 467 (1943) (legal expenses);

North American Investment Co. v. Commissioner, 24 B.T.A. 419 (1931) (settlement payment). But legal expenses and settlement payments incurred to defend or protect title to property are nondeductible capital expenditures. Boagni v. Commissioner, 59 T.C. 708, 713 (1973) (legal expenses); Yates Industries, Inc. v. Commissioner, 58 T.C. 961 (1972), aff'd, 480 F. 2d 920 (3rd Cir. 1973) (settlement payment).

Whether a dispute is resolved through litigation or settlement, the nature of the underlying action determines the proper tax consequences. Tribune Publishing Co. v. United States, 836 F.2d 1176, 1177 (9th Cir. 1988). The taxability of a settlement is controlled by the nature of the litigation. Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir. 1944), affg. 1 T.C. 952 (1943).

The nature of the litigation is, in turn, controlled by the origin and character of the claim which gave rise to the litigation. <u>United States v. Gilmore</u>, 372 U.S. 39 (1963). Both the consequences of the litigation and the taxpayer's motive or purposes in undertaking the litigation are immaterial. <u>Id.</u>

Gilmore involved the issue of whether a taxpayer could deduct a portion of his divorce legal expenses relating to protecting his interest in his business. The Supreme Court determined, using the origin of the claim test, that the expenses were non-deductible personal expenses rooted in the taxpayer's divorce, and were not deductible even though the taxpayer's purpose may have been to protect his business income.

In <u>Gilmore</u>, because the Court attributed the expenses to a purely personal transaction, the characterization of those expenses presented no problem. If the costs had been attributable to a business transaction, it would have been necessary to determine if the costs represented deductible expenses or adjustments to the cost of a capital asset. <u>See Keller Street Development Company</u>, et al. v. Commissioner, 688 F.2d 675 (9th Cir. 1982), aff'g T.C. Memo. 1978-350.

Courts have rejected arguments by taxpayers that the origin of the claim analysis in <u>Gilmore</u> is limited to determining whether income and expenses are business or personal; the same test is used to determine in a business context whether settlement proceeds constitute ordinary income or capital income, and whether a settlement payment constitutes an ordinary and necessary expense, or a capital expenditure. <u>See Anchor Coupling Co., Inc. v. United States</u>, 427 F.2d 429 at 432-33 (7th Cir. 1970) ("Although the two questions are admittedly different, substantially the same problems arise in each determination.")

A significant expansion of <u>Gilmore</u> occurred in <u>Woodward</u>, 397 U.S. 572 (1970), and its companion case, <u>Hilton Hotels</u>, 397 U.S. 580 (1970). In those cases, the Court extended the origin of the claim test to the determination of whether an ordinary and necessary business expense was a currently deductible expenditure or a capital expenditure.

Woodward involved the attribution of various expenses incurred by shareholders in an appraisal action. The taxpayers were majority holders of an Iowa corporation, where state law allowed shareholders to vote on a perpetual extension of corporate charter. If the approval is not unanimous, the dissenting minority holders must be allowed to sell their shares for "real value." In Woodward, the dissenting minority and the majority could not agree on "real value." The majority holders brought an appraisal action. Following resolution of the "real value" issue, the majority holders sought to deduct the cost of the appraisal as an "ordinary and necessary" business expense. The Eighth Circuit disagreed, and disallowed the deduction, Woodward v. Commissioner, 410 F.2d 313 (8th Cir. 1969). The Supreme Court affirmed.

The basis of the taxpayers' argument was that their "primary purpose" in expending the funds was to allow their business to continue. They noted that the appraisal action did not involve any title issues, only the value of the shares. The Supreme Court rejected the "primary purpose" test. "A test based on the taxpayer's 'purpose' in undertaking or defending ... litigation would encourage resort to formalisms and artificial distinctions." Woodward, 397 U.S. at 577. Instead, the Court applied the "origin of the claim" test as established in Gilmore. Woodward, 397 U.S. at 578. The establishment of a price being a crucial part of a purchase of assets, the Court determined that the appraisal action originated in the efforts to buy the stock; thus, the appraisal costs were attributed to the stock purchase. As the purchase of stock was a capital transaction for tax purposes, the cost of the appraisal was characterized as a part of the cost of the stock acquired. It was treated as an adjustment to basis, not a deductible expense. Id. at 578-79.

The companion case, Hilton Hotels, involved the cost of an appraisal arising from dissenters' rights in a merger. taxpayer tried to distinguish Woodward on the ground that title to the stock passed prior to a value being fixed. The court saw no distinction, and applied the same reasoning as in Woodward. Hotels, 397 U.S. at 583-85.

Following Woodward and Hilton Hotels, the Court of Appeals for the Ninth Circuit has explicitly applied the origin test on several occasions. In Redwood Empire Savings & Loan Association v.

Numerous opinions in circuits other than the Ninth Circuit apply the origin rule under many varied circumstances: McDonald v. Commissioner, 592 F.2d 635 (2nd Cir. 1978) (expense in will contest based on personal right under will, no deduction); Newark Morning Ledger Co. v. United States, 539 F.2d 929 (3rd

Commissioner, 628 F.2d 516 (9th Cir. 1980), for instance, the Court, in applying the origin test to determine if defense and settlement costs were deductible, identified the origin of the suit to be a sale of land, and thus characterized the expenditures in the subsequent fraud suit as nondeductible costs going to the price of land. <u>Id.</u> at 520-21. <u>See also Madden v. Commissioner</u>, 514 F.2d 1149, 1151-52 (9th Cir. 1975), <u>cert. denied</u>, 424 U.S. 912 (1976); DeMink v. United States, 448 F.2d 867, 869 (9th Cir. 1971).

The Court of Appeals for the Ninth Circuit has articulated a two-step process for determining the taxability based on the origin ... of the claim. Keller Street Development Co., 688 F.2d at 681-82. As the Ninth Circuit noted, first, a careful reading of Gilmore indicates that the "claim" at issue (the origin of which is to be identified) is not the tax claim, but the underlying claim that gave rise to the settlement proceeds (i.e., the event that prompted the cause of action and formed the basis of the suit). The origin is determined by analyzing the facts and determining the nature of the transaction.

The second step requires the Court to characterize the transaction that it identified in the first step. Id. Litigation proceeds are deemed "capital income" if "the origin of the claim litigated is in the process of acquisition itself." Woodward, 397 U.S. at 572 (1970). Because identifying the origin of the claim as a capital transaction does not automatically resolve the tax

Cir. 1976) (derivative suit not based on concurrent sale of corporation, but rather on management fraud in operation of corporation, cost of suit deductible); Estate of Baier v. Commissioner, 533 F.2d 117 (3rd Cir. 1976) (determination of rights under a patent originated in disposition of capital asset, nondeductible); Brown v. United States, 526 F.2d 135 (6th Cir. 1975) (valuation costs originated in negotiations to sell stock, not deductible); Kimbell v. United States, 490 F.2d 203 (5th Cir.), cert. denied, 419 U.S. 833 (1974) (payment in satisfaction of liability arising from fraudulent sale of capital asset, not deductible); Clark Oil and Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1973) (amount paid to landowner to settle nuisance action not deductible, as origin of dispute was an attempt to acquire the property); Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971) (settlement payment in suit based on breach of contract to sell corporation was a nondeductible capital expenditure); Helgerson v. United States, 426 F.2d 1293 (8th Cir. 1970) (expenses arising from litigation following sale of stock originated in the sale, and are not deductible).

treatment of the payment at issue, a court must next examine how the payment fits into the structure of a capital transaction. Keller Street Development Co., 688 F.2d at 681-82. characterizing the settlement payment for tax purposes, the test to be applied is stated most simply as "[i]n lieu of what were the damages awarded?" See Dye v. United States, 121 F.3d 1399 (10th Cir. 1997).

In determining the nature of the underlying transaction, the origin of the claim test does not call for a "mechanical search for the first in the chain of events which led to the litigation" but rather requires an examination of all the facts to ascertain the "kind of transaction" out of which the litigation arose. Boagni, 59 T.C. at 713; see Spangler v. Commissioner, 323 F.2d 913, 918 (9th Cir. 1963), affg. T.C. Memo. 1961-341.

In some cases, there may be multiple claims. In such cases, the origin of the claim test requires that the litigation expenses and settlement proceeds be allocated among the various claims actually settled. See Dye, 121 F.3d 1399. Where the settlement agreement does not allocate the settlement proceeds by individual claim the Court must determine how the settlement should be allocated among the various claims actually settled. Id. at 1407.

In Dve, the taxpayer placed her municipal bonds and certain shares in the hands of a stockbroker and incurred large losses. The taxpayer sued the stockbroker alleging securities fraud and mismanagement, common law fraud and breach of contract. District Court purported to apply the origin of the claim test to determine whether the taxpayer's \$200,000 in legal expenses were capital or ordinary, and held that:

The amended complaint does not reflect litigation involving the process of acquiring or disposing of assets, but rather a lawsuit to compensate an investor for professional misconduct and to punish the alleged wrongdoers through the imposition of RICO treble damages or garden variety punitive damages. The expenses incurred in doing so are not capital in nature and are deductible, if at all, as ordinary business expenditures.

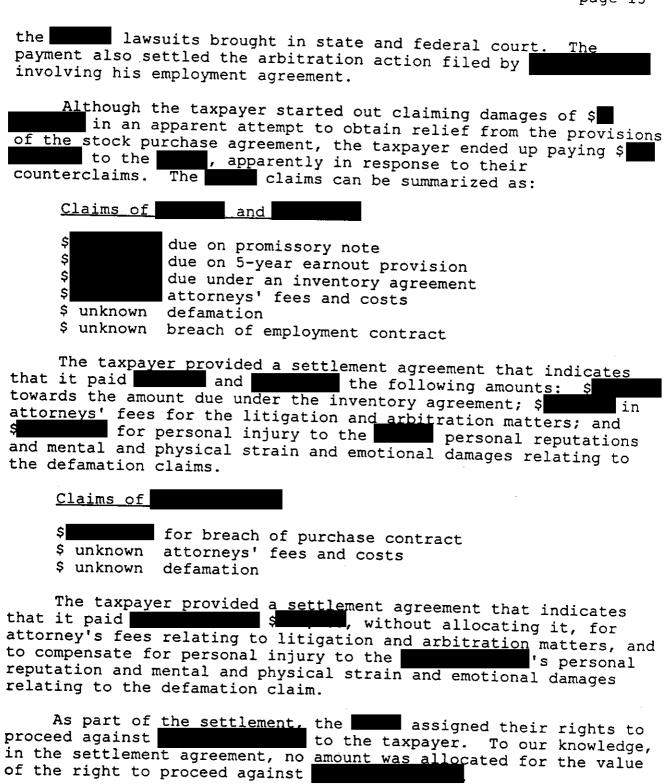
Dve v. United States, 96-1 U.S.T.C. ¶ 50,130 (D. Kan. 1995). In reversing and remanding the case, the Circuit Court noted that:

In our view, the district court erred in treating the legal expenses as a unified whole, rather than attempting to allocate them based on their respective "origins" in each of [the taxpayer's] legal claims. Where, as here, the litigation involves more than one claim, "[t]he

origin [of the claim] test must be applied separately to each part." Dolese v. United States, 605 F.2d 1146, 1151 (10th Cir. 1979), cert. denied, 445 U.S. 961 (1980). Legal fees, like other expenses, may, under certain circumstances, be partially deductible and partially nondeductible. See, e.g., Treas. Reg. § 1.212-1(k) ("Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents."); see also Boagni v. Commissioner, 59 T.C. 708, 713-14 (1973) (recognizing that legal expenses can be characterized as both deductible and nondeductible when the litigation is rooted in situations giving rise to both types of expenditures). Consequently, when litigation originates in claims that are both capital and ordinary in nature, the litigation expenses should be allocated between the capital and ordinary income claims. See e.g., Burch v. United States, 698 F.2d 575, 579-80 (2nd Cir. 1983) (taxpayer's legal expenses "should be apportioned between those devoted to establishing [taxpayer's] title to the trust property, which are non-deductible capital expenses, and those devoted to reducing [certain trustee] fees, at least some of which appear to have been deductible expenses for the management of incomeproducing property. Such an allocation between deductible and non-deductible expenses is not unusual, although a rough approximation is all that can be expected.") (footnote, citations, and interior quote marks omitted); accord, Nickell v. Commissioner, 831 F.2d 1265, 1275-76 (6th Cir. 1987).

Dve, 121 F.3d at 1406. In Dve, since the taxpayer's claims included not only claims for recovery of ordinary income, but also for the recovery of capital assets, the Circuit Court concluded that the origin of the claim test required an allocation of both the settlement proceeds and the litigation expenses to their origins in each of the taxpayer's claims. Since the settlement agreements did not specifically allocate the settlement proceeds, the Court had to address how such an allocation might be made. The Court also had to address how the related legal expenses should be allocated. In conclusion, the Court reversed the District Court and remanded the case for the District Court to allocate both the settlement proceeds received, and the legal expenses paid, between ordinary and capital.

In the instant case, the taxpayer paid \$ in taxable year to settle the counterclaims raised by



On the taxpayer's return, the taxpayer apparently did not deduct the \$ ____ that it paid pursuant to an inventory agreement. The taxpayer appears to have capitalized \$ was paid to and and on the promissory note, and

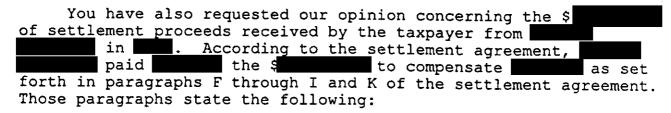
appears to have capitalized \$ as a reduction of purchase price (we assume that this means additional purchase price paid by the taxpayer for the stock). The taxpayer classified \$ as interest, which it apparently deducted as interest expense. The taxpayer appears to have deducted from ordinary income virtually all of the entire remaining settlement amount, plus \$ of attorneys' fees. We do not know whether the \$ of attorneys' fees constitutes all of the attorneys' fees paid by the taxpayer, or whether there were additional attorneys' fees that may have been capitalized.

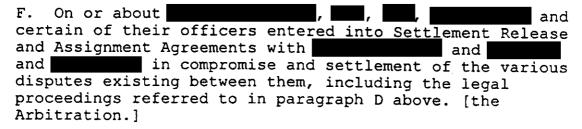
We made the following observations after examining the claims raised in the pleadings, the purported allocations in the settlement agreement, and the treatment on the taxpayer's return. The original claims of the taxpayer appeared to be an attempt to obtain relief from having to fulfill its outstanding obligations under the stock purchase agreement. The counterclaims by the performance under the stock purchase agreement, and under the employment contract. The counterclaims of the employment contract. The counterclaims of the employment classifies a substantial percentage of the payment as personal injury damages based on defamation, despite the fact that the pleadings reflect that they were seeking substantial damages based on the sale of their stock.

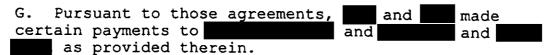
Although it appears that the taxpayer has capitalized a portion of the settlement payment, it appears that a large portion was currently deducted, and that, perhaps, some, if not all, of the currently deducted amount should have been capitalized. payment by the taxpayer of the \$ _____ appears to originate primarily in the acquisition of the stock by the taxpayer, and, probably should be capitalized, except to the extent that some other appropriate treatment may relate to the amount paid pursuant to the inventory agreement, or in resolution of a breach of employment contract claim. A portion of the settlement payment may 's separate arbitration action concerning be related to the taxpayer's alleged breach of his employment contract. possible that, whatever that portion may be, it may have been paid in lieu of wages, and, thus, may be currently deductible. extent that a portion of the settlement payment may in fact constitute compensation for personal injury damages, we believe that as the payment arose not in the taxpayer's ordinary course of running its business, but rather appears rooted in the stock

acquisition, even an amount for personal injury damages should be capitalized.9

We note that the taxpayer has deducted attorneys' fees in excess of \$ _____ The total attorneys' fees related to the arbitration and to the litigation need to be determined. It would appear appropriate that the attorneys' fees should be allocable to currently deductible expense and capital expense in the same proportion as the settlement payment.







- H. Pursuant to those Agreements, and and assigned to any and all claims which they held, or may have held, against as set forth therein.
- I. The believe that they would have prevailed in the legal proceedings involving the

We acknowledge that legal expenses and settlement costs incurred in defending against a claim of fraud that would injure or destroy a business have been held to be ordinary and necessary business expenses. Commissioner v. Heininger, 320 U.S. 467 (1943) (legal expenses); North American Investment Co. v. Commissioner, 24 B.T.A. 419 (1931). In this case, such an analysis would seem to be looking to the taxpayer's "primary purpose" in defending the litigation, rather than looking to the origin of the claim. Any fraud on the Taxpayer's part would not seem to have arisen during the ordinary course of its business, but rather as part of its acquisition of the

referred to in paragraph D [the Arbitration] above and recovered substantial sums from the had it not been for certain conduct of , its partners and/or its employees (1) during the course of the transaction by which [acquired from the and (2) in connection with production of documents during the course of the legal proceedings referred to in paragraph D above [the Arbitration].

- In order to resolve the dispute that has arisen between them, and and and and and have agreed to enter into the following Settlement Agreement.
 - shall pay to the total sum of \$
 - 2. In consideration of the foregoing, the ... and ... hereby mutually relieve, release and forever discharge each other

The claim that resulted in receiving the \$ appears to have its origin in the arbitration. actionable conduct occurred during the arbitration in that it failed to disclose, until the 11th hour, certain internal memoranda reflecting negatively on it and . Alternatively, it could be viewed that 's negative conduct occurred during the original acquisition process when it apparently failed to disclose to the its relationship to 's German parent. Again, alternatively, perhaps a court would find that the origin of the claim is partly in the arbitration and partly in the acquisition. We think that the result is the same under any of these views, i.e., the origin of the claim is the same as the claims which led to the settlement payment.

The answer to the question "[i]n lieu of what were the settlement proceeds paid?," is that the settlement proceeds were to compensate for the additional consideration it had to pay the to settle the arbitration. It is appropriate that the treatment of this "reimbursement" from the be allocated along the lines of the \$ settlement paid by the Taxpayer to the ____. Accordingly, we think that, whatever the appropriate treatment of the settlement expenses, the same treatment should be accorded the settlement receipts.

If you have any questions, please call the undersigned at

Assistant District Counsel

By:

Attorney